U. S. S E N A T E
Republican Policy Committee

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What Happened to Re-Inventing Government?

The Department of Education's Takeover of Student Loans: Don't Bank on Success

Eliminating the government's middle man doesn't always lower costs. That's certainly the case when it comes to the federally-administered student loan program. President Clinton's claim has been that the Department of Education can run the program better than private banks, and that it should run the program entirely. Taxpayers are right to be wary. In this case, the middle man is the private sector, and taking it away creates a new government monopoly.

Despite assertions to the contrary, Congress in its efforts to reduce the federal deficit is ***not*** contemplating **any changes that would in any way jeopardize the availability of student loans** for those who depend on them to further their education. Rather, efforts are being made to assure the program is preserved and protected, and that the funds are available for the thousands of students who depend on them. The key issue this year regarding student loans is ***the means*** by which the loans are distributed. That is, should government take over the program?

The Federal Student Loan Program: Guaranteed vs. Direct Loans

For the last 30 years, students seeking federal assistance in obtaining college, trade, or technical school loans have borrowed money from private financial institutions under a federal program popularly known as the Guaranteed Student Loan program (now called the Federal Family Education Loans, or FFEL). Under this program, the federal government guarantees the repayment of the loans, and private-sector entities called guaranty agencies do much of the administrative work. In FY93, this program supported $16.5 billion in loans for postsecondary student expenses.

If President Clinton gets his way, the government will take over the entire student loan program using federal — not private — capital. The President is arguing that the success of the newly created Direct Student Lending program — which is now in effect only in very limited form — demonstrates that a federal bureaucracy, namely the Department of Education, can distribute, administer, and collect student loans more effectively and at less cost than the

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private sector. The argument is that such a program will be more efficient and "user friendly."

Yet, if this government takeover occurs, the Department of Education will in effect become one of the largest banks in America, and it may fall upon the IRS to become one of the major loan collectors in the nation, using critical government resources to service, and then attempt to collect billions of dollars. Interestingly, the President has not addressed the issue of how his "super-efficient" Department of Education is going to collect on the $85 billion in outstanding FFEL student loans projected for the end of FY96.

The Direct Student Loan program was enacted in 1993. The Omnibus Budget Reconciliation Act limited the new program's direct government lending to 5 percent of total volume of all federal student loans for the 1994-95 academic year, and limits direct student lending to 40 percent for the 1995-96 academic year, growing to 60 percent for the academic year 1998-99. The FFEL would continue to make up the remainder of the loan volume.

In his February budget request, President Clinton proposed accelerating the phase-in of direct government lending. This acceleration calls for direct lending to account for 80 percent of loan volume in the academic year 1996-97, and 100 percent thereafter — eliminating guaranteed student loans.

How to Measure Success

Certainly, the President's assumption of the program's success is premature. The direct lending program only began last year, with some 100 participating schools out of some 7,000 in the current guaranteed loan program, and was in its first year limited to 5 percent of the total federal student loan volume. While some schools and students may be cheering the initial efficacy of the loan origination process, most taxpayers would agree that the measure of success should be the degree of repayment, and other overall cost reductions to the government.

Originally, the Administration proposed that the government take over student loans because of the favorable budget impact — the Congressional Budget Office (CBO) scored the action as a $12 billion savings over fiscal years 1995-2000. It now appears — based on more recent CBO numbers — that this figure is highly overstated, and in fact, it now looks as though the elimination of the direct program, in favor of fully replacing it with the traditional guarantee program, will **save** taxpayers as much as **$1.5 billion** over seven years.

Why the big discrepancy in the savings between the two student loan programs? In part, it is because (due to federal budget scoring methodology) the Credit Reform Act of 1990 did not require counting overhead costs for the direct lending program to be taken into account. However, administrative costs are counted when figuring the budgetary impact of the FFEL.

Additionally, the savings included **all** those stemming from the 1993 Student Loan

Reform Act (SERA), including those savings realized in the guaranteed loan program (FFEL) — namely the elimination of more-than-competitive returns to lenders. It is misleading to claim these savings — scored at $2 billion — result from elimination of the guaranteed program because they would be realized whether the guaranteed loan program were eliminated or not.

Elimination of the direct lending program would have **no effect on the volume of money loaned to students.** It simply means that students would, as they have for three decades, borrow from banks, and be expected to begin repaying upon graduation over a 10-year period.

Direct Lending Will Greatly Increase the Deficit

Another criticism lodged against direct lending is the effect on the deficit. According to Congressman Ernest Istook (R-OK) in testimony before the House Economic and Educational Opportunities Committee last spring, a complete takeover of the student loan program by the federal government could add at least **$348 billion** to the national debt by the year 2014 (see chart).

Even if the Clinton Administration fails at a complete takeover of the student loan program, current law allows direct loans to make up 60 percent of all new student loans in the next school year. At this level of government lending, the Treasury will need to borrow an additional **$63 billion** a year by 1999 alone.

The income contingency repayment feature of Clinton's direct student loans remains controversial. It can be expected to increase costs both to the federal government and to borrowers. This feature — which is not in the guaranteed loan program — allows students to pay only a percentage of their income toward their loans instead of the full monthly payment. A student with a low-income producing job may end up paying an amount that does not even equal the monthly interest due, thereby increasing, not decreasing, the principal of the loan, resulting in negative amortization. The Department of Education itself projects that more than half of the borrowers who choose this payment plan would end up with negative amortization. Thus, we have a government program that encourages people to increase their indebtedness.

This payment method also allows borrowers never to repay their debts. If they have failed to pay back their loans after 25 years, the loans are forgiven by the federal government. This feature alone can be expected to add to the cost of the direct lending program compared to the guaranteed loan program. Since borrowers under the direct lending program are allowed to pay less than the interest due on their loans, and are also allowed to default on their loans after 25 years, private investors purchasing direct loans in the secondary market will pay a lower price for direct loans than they would for comparable guaranteed loans.

Another factor that will greatly increase the cost of direct student loans is the new bureaucracy that will have to be created to oversee this program. Already, the Department of

Education has hired some 350 new employees to administer direct student loans — and this year the program's loan volume was only at 5 percent — and by their own account will hire an additional 170 by 1997. Critics contend that this hiring binge is just the tip of the iceberg, and that the Department of Education will hire hundreds more to feed its bureaucratic appetite.

Clinton has said he wants all schools to participate in his program rather than in the guarantee program. The main reason he needs this mandate is that it's the only way his boat will float: It appears that his program is attracting more schools with high default rates (trade schools traditionally average about 30 percent in defaults). Clinton needs all of the four-year colleges (with their historically lower default rates) to participate so as to keep costs and default rates down. Education Department regulations allow schools to be eligible for participation if they've had a default rate below 25 percent in just **one of the past three years.**

Is the Department of Education Up to the Task?

In 1972, the federal government made its most recent attempt at direct student lending through the Federally Insured Student Loan program (FISL). The FISL was closed down in 1981 after Congress found gross mismanagement of the program. Congress found that student loan default rates were higher under FISL direct lending than they had been under the guaranteed loan program. Out of the $7.4 billion in direct loans made throughout the FISL's existence, defaults accounted for $1.3 billion — a 17.5 percent default rate.

Following the dismantlement of the FISL, student loans reverted back solely to those privately funded but federally guaranteed.

A continuing lack of competency in this arena was recently demonstrated by the revelation that the Education Department in 1994 disbursed nearly $700 million in direct loans, yet is now unable to account for 15 percent of these loans. In other words, the Department does not know who borrowed some $100 million, or where this money is [Forbes, 5/22/95, pp. 122-128].

Reform the Current System Rather Than Abandon It

The current system is not perfect. Changes can and should be made to allow the process to be less complex for both the student-borrower and participating schools. Reforms Congress may want to consider include providing more services to schools by guaranty agencies, sharing of electronic data systems, and the availability of more advantageous terms for borrowers. Such incentives as Sallie Mae's (Student Loan Marketing Association, which purchases many student loans) to reduce interest rates for borrowers who make their first 48 monthly payments on time, are positive changes. Can we expect to see such innovations in a government-run system? Looking at other government programs, it is fair to suggest that government is more likely than the private sector to misdirect incentives.

The Better Banker, or Rationale to Save the Department?

Before counting his chickens, the President ought to see how well the program withstands a change in its lending volume from 5 percent of total loan volume to 40 percent, the amount allowed under current law for the 1995-96 school year. However, it is possible we will not be able to witness this because early indications are that not enough schools have participated to assure the maximum volume.

If we eliminate the direct lending system and return to the guaranteed loan system, savings can be applied back into the program to help more students. For example, Chairman Buck McKeon (R-CA) of the House Subcommittee on Postsecondary Education, Training and Life-Long Learning has suggested the $1.5 billion in savings from elimination of the direct program could be directed toward allowing the continuation of the in-school interest subsidy for graduate students, many of whom will become highly-paid lawyers and doctors (the suggestion of the possible elimination of that subsidy was included in the FY96 budget resolution).

Perhaps, since savings can no longer be the driving force behind this pursuit of policy change by the Clinton Administration, one should look at politics. Calls by some Republicans after the 1994 elections to eliminate the Department of Education may have given the President renewed vigor in pursuing this policy. Allowing the Department of Education to take over the student loan program would give it a new reason for continued life.

The day we have proof that the federal government can run a program better than the private sector is the day we should applaud President Clinton's plan to have the government completely take over the student loan program.

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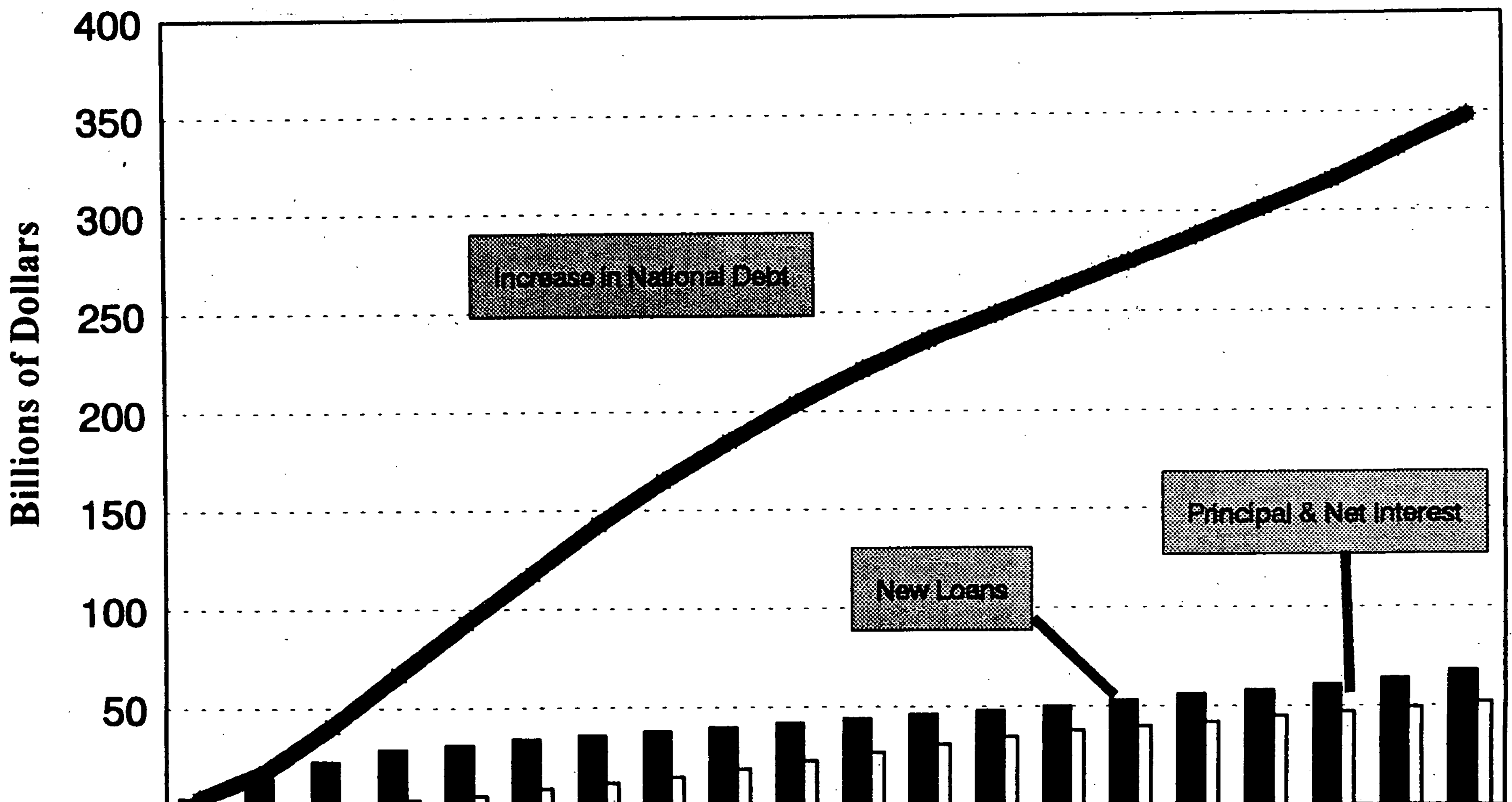
Direct Lending's Impact on National Debt



Fiscal Year	1995	96	97	98	99	2000	01	02	03	04	05	06	07	08	09	10	11	12	13	14
New Loans	4	14	23	29	31	34	36	38	40	42	44	46	48	50	53	56	58	61	64	68
Principal & Net Interest Pmt	0	0	1	3	5	9	12	15	19	23	27	31	35	38	40	42	45	47	49	52
Incrase in National Debt	4	18	41	67	93	118	143	165	185	204	221	236	249	262	275	288	302	332	348	348

Source: Rep. E. Istook

Chart Assumptions:

- Volume FY1995-FY2000 based on government numbers published on 2/95.
- Direct Lending - Academic Year: 94/95 - 5%, 95/96 - 40%, 96/97 - 80%, 97/98 - 100%.
- Volume growth FY2001 - FY2014 - 5% per year.
- Loans enter repayment 2 years after origination.
- Loans are repaid over 10 years with equal payments to principal.
- 10% of the original loan amount defaults or is forgiven.
- Increase in National Debt = Cumulative New Loans less Principal & Borrower Net Interest Payments.
- Net Interest Payments (prom note rate less government cost of funds) = 2% of the increase in National Debt.
- Does not include FFEL loans consolidated into FDLP.
- Does not include administrative expenses or interest subsidy.

Source: Rep. E. Istook (R-OK)